Economic Commentary – July 2016

Overview

The FTSE 100 is now at 6,693, having started the month of July at 6,577 and started the year at 6,242. Initial market reaction to the UK's vote to leave the EU was negative but very short-lived as stocks and bonds responded positively to expectations of a continuation of loose monetary policies. Sterling hit a 31-year low against the US Dollar on 5 July following the Referendum and remains comparatively low at 1.32 Dollars to the Pound. Currency translation effects have led to positive Sterling-based returns for global assets and company revenues.

There are still some significant global risks though - excessive debt, stagnant productivity, deteriorating demographics across developed economies and a prolonged slowdown in China. The latest global growth outlook was published by the International Monetary Fund last week. It cut its 2016 global growth forecast from 3.2% to 3.1%, and its 2017 forecast from 3.5% to 3.4%.

There are also political risks in play in the run up to the US presidential election and as the UK continues its negotiations with the European Union. This leads us to remain cautious and to expect markets to be unsettled in the coming months.

We are also keeping a close eye on the valuation of "bond proxies" – equities with a decent, secure, sustainable yield which can provide an income stream. Many of these stocks are now trading at very high valuations and we are monitoring how the managers of our preferred funds are approaching this situation.

Bonds, Property and Cash

Sovereign bond markets remain highly distorted. $12 trillion of debt globally has a negative yield creating a guaranteed loss if held to redemption. In the immediate aftermath of the Referendum 10-year benchmark Gilt yields fell below 1% for the first time in history and the yield is now 0.72%. The respective German Bund is yielding -0.09%. We simply will not buy investments which are seriously overvalued, carry the risk of irrecoverable capital losses and offer negligible or no yield.

Low returns in bond markets have led some investors to move into property funds in search of a higher yield. We have consistently had a negative or neutral view on property within our asset allocation in the last 3 years and this has been partially driven by concerns regarding liquidity. These concerns were vindicated in the last month when most of the largest property funds in the UK either temporarily suspended redemptions or adjusted the pricing of their assets. The appearance of liquidity offered by a daily trading property fund can prove illusory at times of market stress.

We believe that a similar situation could occur with corporate bond funds. In 2008 the corporate bond market became extremely illiquid almost overnight. Since that time many funds investing in corporate bonds have experienced substantial inflows and have grown to very large sizes of up to £14 billion. There are also a number of exchange-traded funds investing in the corporate bond sector, some of which do not actually invest in the underlying bonds but instead use complex derivatives to mimic the performance of the bond index. We believe that both types of fund could be at risk should large scale redemptions occur at a time of market stress and that some might be in a situation where redemptions had to be suspended. Liquidity risk is combined with the risks of capital loss associated with high valuations and we continue to avoid corporate bond investment.

We expect inflationary pressures to begin to build as commodity prices increase and due to imports becoming more expensive because Sterling is weaker. Nearly one-third of the basket of goods used to calculate CPI is imported. Rising inflationary pressures are a risk to the purchasing power of cash. Nevertheless, we continue to believe that a tactical cushion of cash should be held to deploy if a market correction occurs. It is easier to take advantage of market falls when they occur than to avoid the market falls themselves.

UK

The initial second quarter GDP growth figures of 0.6% quarter-on-quarter and 2.2% year-on-year suggests there was no slowdown ahead of the Referendum. In the short term, the UK economy may experience deceleration following the Referendum but we believe that monetary and fiscal policy measures and Sterling devaluation should mean a full blown recession is avoided.

We remain cautious with regard to UK equities because whilst some companies may benefit from a lower exchange rate, more domestically orientated companies may face a difficult period and careful stock selection is imperative. We have already met with and spoken to a number of our core UK fund managers in recent weeks including Richard Colwell of Threadneedle UK Equity Income, Hugo Ure of Trojan Income and Nigel Thomas of Axa Framlington UK Select Opportunities. Meetings with Adrian Frost of Artemis Income and Neil Woodford of Woodford Equity Income are scheduled for September.

US

The S&P 500 index climbed to new highs in the last month and ended July at 2,173.60, two points below its all-time high. In the absence of solid earnings growth we remain concerned about equity valuations in the US. The long term price/earnings ratio for the US market is now 26.95 compared to an average of 16.68 and a median of 16.04 indicating that the market is comparatively expensive. We therefore remain cautious with regard to the US.

Most of our US exposure is obtained through our carefully selected global funds and we are looking to take profits from our specialist US funds. This will also allow us to crystallise some gains from the devaluation of Sterling.

Europe

European growth remains lacklustre and GDP was up by only 0.3% on the previous quarter by the end of June. Additionally, the Euro area financial system remains fragile. We therefore retain a very selective approach to European equities based on high quality, cash generative companies operating in a niche sector.

Asia Pacific and Emerging Markets

We continue to focus on high quality investments in the Asia Pacific region centred upon companies with good corporate governance and robust business models. We avoid direct investment in emerging markets based on the market volatility and unpredictability of the countries in this sector, which was highlighted again this month with the attempted coup in Turkey.

Alan Torevell and Georgina Ogilvie-Jones